

Weekly Report

Will fiscal policies derail world economic growth ?

The consensus seems to perceive that "Greek" troubles have transformed to a problem at the "periphery" of Europe. With Spain as the fourth largest economy and Italy as the third important country showing strong signs of distress we consider such an assessment as superficial. Europe at its heart is concerned. The notion that the weak EUR will help economic growth is relative as Germany, which is already the strongest member, will mostly benefit from the dwindling currency. We therefore assume that economic growth forecasts will have to be reduced further. But even more importantly, the debt crisis may lead to devastating impacts on financial markets. This concrete fear prompted most likely the gigantic EUR 750 billion package orchestrated by European Finance Ministers. The tightness in money markets and the money parked with the ECB are strong indications that commercial banks are reluctant to lend to each other...sounds familiar? To prevent a repetition of a debt crisis only a short while after the first shock and in an environment of still fragile financial institutions, which additionally will face regulations and legal cases, central banks reacted worldwide. What Europe made crystal clear is that fiscal reforms will have to be attacked swiftly and thoroughly. This concerns of course also the UK, the US and Japan. Beyond, it demonstrates that imbalances have to be corrected sooner or later. This applies to China as well, which for years accumulated FX reserves in order to stimulate exports. China additionally faces a real estate bubble triggered by ballooning cheap loans. Economic growth worldwide faces hurdles.

Foreign Exchange

The USD takes it all. The only main currency which moved sideways has been the JPY, probably benefiting from the "safe haven" status and reduced net shorting. The election in the UK finished in a surprising coalition. Interestingly, the two parties seem indeed willing to use the full legislative period to change Britain's political landscape. David Cameron and Nick Clegg positively surprised the public with the level of harmony, pragmatic thinking and swiftness when presenting the coalition program and the filling in of ministerial positions. The priority of the new coalition consists of restoring the country's financial situation by concurrently protecting the economic upswing. Despite this positive intentions the GBP was again under strong selling pressure after the new Prime Minister said the government discovered very bad spending decisions by the previous administration. The new Chancellor of the Exchequer, George Osborne, will present an emergency budget on June 22 and sees a strong case for £ 6 billion of immediate cuts to reduce the budget deficit.

| | Short-term trend | Last |
|--------|------------------|--------|
| EURUSD | ↓ | 1.2331 |
| USDCHF | ↑ | 1.1356 |
| USDJPY | ↑ | 92.315 |
| GBPUSD | → | 1.4424 |

Fixed Income

The 3-month-fix-USD-Libor rose from 0.25 % mid February to now 0.46 %, which is the highest level in more than nine months. It reflects the high level of demand for the US currency as a consequence of the European sovereign debt crisis. The Libor-OIS (Overnight Index Spread), which indicates lending activity between banks, has widened to 0.25 percentage points. The spread usually oscillated around 0.10 percentage points since August. The reluctance to lend has clearly risen despite the colossal bailout plan. While the spread is still far away from the levels we have seen in the peak of the previous debt crisis, the rising trend is disconcerting, particularly given the measures already taken by central banks: The US Federal Reserve has reopened USD currency swaps with central banks in Europe to alleviate funding pressures. We expect Libor rates to continue to rise as we consider that the root of the problem in the Eurozone has not been erased. EC president Barroso stated: "One cannot have a monetary union without an economic union. Members need to have the courage to express themselves if they want this or not."

| | Forecast end 10 | Last |
|------------|-----------------|--------|
| US 10y T % | 4.80 | 3.46 |
| Fed funds | 2.00 | 0-0.25 |
| Bund 10y % | 3.70 | 2.86 |
| ECB rates | 1.00 | 1.00 |

Stocks

Given the more difficult economic environment and the extremely volatile market environment, a more conservative posture should be favored. While some market participants consider European stocks now as very attractively valued, we would caution that the valuation is attractive for a reason: European stocks have a stronger cyclical component. Given that the economic prospects have clearly deteriorated we would not favor European stocks. The visibility for certain segments is particularly turbid, which is especially true for European banks. Stable cash flow generation, independent of economic growth, seems currently a safer strategy. Nestle (NESN VX), which reported better than expected 1Q sales due to broad-based growth across divisions and products seems a favorable stock to hold in this environment. In the US, our favored choice would be General Mills (GIS), which is attractively positioned in more healthy categories. Additionally, market share gains seem probable given the expansion in distribution. The company is also less exposed to Europe than many of its competitors.

| | Forecast end 10 | Last |
|--------------|-----------------|------|
| S&P 500 | 1230 | 1119 |
| NASDAQ | 2450 | 2315 |
| DJ STOXX 600 | 270 | 248 |
| SMI | 7000 | 6429 |